

Tax-Exempt Entities: UBIT and Debt-Financed Income

Exempt organizations, like for profit corporations and individuals, are often approached by the owner of a parcel of real property with an offer to sell the property to the organization at an attractive price. The property may be suitable for eventual use towards the organization's exempt purpose, or may just represent a good investment. If the tax-exempt entity decides to proceed with the acquisition, it may be necessary to borrow part or the entire purchase price. However, the purchase should be approached with caution, as the ownership of debt-financed property may cause the recognition of unrelated business taxable income.

In General. An exempt organization is subject to the unrelated business income tax, a tax on certain business income that is imposed notwithstanding the organization's exempt status. Normally, investment income is not subject to the unrelated business income tax; however, such income is taxable if it is derived from debt-financed property. In general, debt-financed property is property, other than property used by an organization in its exempt function, that is acquired with borrowed funds. For example, dividends and real estate rentals are typically not covered by the unrelated business income tax. However, if an exempt organization purchases corporate securities or rental real estate with borrowed funds, all or part of the dividends or rental income from the property may be subject to the unrelated business income tax.

Debt-financed Property. Debt-financed property is property that is held to produce income and with respect to which there is "acquisition indebtedness." Acquisition indebtedness is indebtedness incurred in connection with the acquisition or improvement of property, whether the indebtedness is incurred before, after, or at the time of the acquisition or improvement.

The term "debt-financed property" is subject to several exceptions. The most important exception relates to property used by an organization in its exempt function. Debt-financed property does not include any property, 85% or more of which is used in relation to an exempt function. If the entire property is not relieved from classification as debt-financed property under the 85% test, property may still escape debt-financed classification if its use is substantially related to the organization's exempt function.

Under certain circumstances, land acquired for prospective use in an exempt function is not treated as debt-financed property during the period prior to its conversion to the exempt use; however, there are several limitations on the application of this exception. For example, the

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conversion to an exempt use must occur within 10 years from the acquisition of the property, and the property must be in the neighborhood of other land owned by the organization. Although, if the organization actually converts the property to an exempt use within the 10-year period, the property is not debt-financed property irrespective of whether it is in the neighborhood of other property owned by the organization, and the organization is entitled to a refund of any taxes paid before the conversion. Also, if there is a structure on the land when it is acquired by the organization, the intended exempt use must entail the demolition or removal of the structure.

Calculating the UBTI on Debt-financed Property. A debt/basis percentage is used to determine the amount of income and deductions with respect to debt-financed property that must be taken into account in computing unrelated business taxable income. The debt/basis percentage is a fraction, the numerator of which is the “average acquisition indebtedness” and the denominator of which is the “average adjusted basis.” Average acquisition indebtedness is the average amount of the acquisition debt during the period the organization owns the property during the taxable year. The average adjusted basis is the average of the adjusted bases on the first and last days of the taxable year. For example, assume that an exempt organization owns an office building, all of which constitutes debt financed property. If the rental income from the building is \$10,000 and the debt/basis percentage is 50%, the organization must include \$5,000 in unrelated business taxable income.

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